

**Introduction**

A succession of highly publicized failures of government securities broker/dealers occurred from the mid-1970s to the mid-1980s (e.g., Drysdale, Lombard-Wall, E.S.M.) causing large losses to investors. Four practices were common to the failed government securities broker/dealers:

- Selling multiple interests in the same securities under several repurchase agreements while maintaining custody of the securities and the pledging of customer securities without transferring title or possession;
- Inadequate collateral given to customers when the broker/dealer engaged in repurchase transactions with customers or excessive collateral demanded when reversing securities from customers;
- Poor recordkeeping; and
- Inadequate capital.

As a result of these failures and improper practices, Congress was impelled to exercise its authority over the largely unregulated government securities market through passage of the Government Securities Act of 1986 (GSA). The stated purpose of the GSA and its implementing regulations is to enhance the protection of investors in government securities by establishing and enforcing appropriate financial responsibility and custodial standards.

The GSA applies to all financial institutions that engage in government securities activities. For the purposes of the GSA, government securities include:

- U.S. Treasury bills, bonds, and notes;
- Discount notes, bonds, certain collateralized mortgage obligations, pass-throughs, master notes, and other obligations of the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), the Student Loan Mar-

keting Association (SLMA), the Farm Credit System (FCS), and the Financing Corporation; and

- FNMA or FHLMC stock.

"Off-exchange" puts, calls, straddles, and "similar privileges" on government securities are considered to be government securities except for the rules addressing custodial holding of securities.

**Custodial Holding Requirements**

All thrift institutions that hold government securities as fiduciary, custodian, or otherwise for the account of a customer (including a counterparty to a hold-in-custody repurchase agreement) must comply with the requirements relating to the safeguarding and custody of those securities. All government securities held for customers, including those subject to repurchase agreements with customers, must be segregated from the thrift's own assets and kept free from lien of any third party or the thrift. A thrift that holds securities held for a customer through another institution, a custodian institution, must notify that custodian institution that such securities are customer securities. The custodian institution must maintain the customer securities in an account that is designated for customers of the thrift. The thrift must notify the custodian institution that these securities are to remain free of any lien, charge, or claim. In turn, the custodian institution, upon the instruction of the thrift, is required to treat the securities as customer securities and maintain those securities in accordance with 17 CFR § 450. The custodian institution does not have to keep records that identify individual customers of the thrift.

When a thrift maintains customer securities in an account at a Federal Reserve Bank, it is considered to be in compliance with the requirements to hold customer securities free of lien if any lien of the Federal Reserve Bank or other party claiming through it expressly excludes customer securities.

The thrift is not required to maintain customer securities in a separate custody account at the Federal Reserve Bank, although segregation is encouraged. The thrift must segregate the customers' securities on its own records.

A thrift may lend customer securities held in safekeeping to third parties and remain in compliance with the GSA as long as any securities loans are made under a written agreement with the customer and in compliance with OTS and FFIEC guidelines for securities lending.

An institution engaged in safekeeping U.S. Government securities for customers is required to issue to the customer a confirmation or safekeeping receipt for each government security held that identifies the issuer, maturity date, par amount, and coupon rate of the security being confirmed.

#### *Recordkeeping Requirements*

The institution must also maintain a recordkeeping system of government securities held for customers that is separate and distinct from other records of the institution. These records must: (1) identify each customer and each government security held for a customer; (2) describe the customer's interest in the security (e.g., pledged to secure a public deposit), and (3) indicate all receipts and deliveries of securities and cash in connection with the securities. A copy of the safekeeping receipt or confirmation given to customers must be maintained. The institution is required to conduct a count at least annually--and document it within seven days--of physical securities and securities held in book-entry form.

An annual reconciliation with customer account records must also be performed. In order to count securities held outside the thrift, such as book entry securities held at a Federal Reserve Bank, the thrift must reconcile its records to those of the outside custodian. Any securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive or deliver, or subject to a repurchase or reverse repurchase agreement must be verified when they have been out of the thrift's possession for longer than 30 days. All custodial holding requirement records must be maintained in an easily accessible place for at least two years and not disposed of for at least six years. This system of rec-

ords must provide an adequate basis for an audit. Additional information on custodial and fiduciary holdings, including examination procedures and an examination checklist, can be found in Trust Activities Handbook Section 300, Operations and Internal Controls.

#### **Hold-In-Custody Repurchase Agreements**

All thrift institutions that engage in repurchase transactions and/or forward repurchase transactions ("forward repos") with customers while retaining custody or control of government securities ("hold-in-custody" repurchase transactions) must comply with the GSA requirements relating to written agreements, confirmations, and disclosures. Forward repos are repurchase and reverse repurchase transactions that settle in a next-day or longer timeframe. Repurchase transactions for the purposes of the GSA may be characterized and accounted for by the parties as either a sale and repurchase of a security or as a secured loan. Securities are considered to be retained in custody even when the securities are maintained through an account at another institution and the securities continue to be under the control of the thrift. All hold-in-custody repurchase transactions are required to be conducted pursuant to a specific written repurchase agreement. If the customer agrees to allow substitution of securities in a hold-in-custody repurchase transaction, then authority for the financial institution to substitute securities must be contained in the written repurchase agreement. In all hold-in-custody repurchase agreements where the financial institution reserves the right to substitute securities, the following disclosure statement must be prominently displayed in the written repurchase agreement immediately preceding the provision allowing the right to substitution:

#### **REQUIRED DISCLOSURE**

The (seller) is not permitted to substitute other securities for those subject to this agreement and, therefore, must keep the (buyer's) securities segregated at all times, unless in this agreement the (buyer) grants the (seller) the right to substitute other securities. If the (buyer) grants the right to substitute, this means that the (buyer's) securities will likely be commingled with the (seller's) own securities during the trading day. The (buyer) is

advised that, during any trading day that the (buyer's) securities are commingled with the (seller's) securities, they may be subject to liens granted by the (seller) to third parties and may be used by the (seller) for deliveries on other securities transactions. Whenever the securities are commingled, the (seller's) ability to resegment substitute securities for the (buyer) will be subject to the (seller's) ability to satisfy any lien or to obtain substitute securities.

No editing or paraphrasing of the above language of the required disclosure statement is permitted under the regulation, except for inserting the appropriate names for the buyer and seller. Any thrift issuing a hold-in-custody repurchase agreement must disclose to the customer in writing that the funds held pursuant to the repurchase agreement are not a deposit and are not federally insured.

Written confirmations describing the specific securities subject to the transaction must be sent to the customer by close of business on the day on which the trade takes place, as well as on any day on which substitution of securities occurs. Issuance of confirmations on the trade date for forward repo transactions in government securities is especially important since these transactions usually settle in a longer timeframe than normal settlement. Confirmations must identify the specific securities by issuer, maturity, coupon, the money or the par amount, market value, CUSIP or mortgage pool number of the underlying securities, and whether there are any rights of substitutions. Market value is defined as the most recently available bid price for the security, plus accrued interest.

Pooling of securities as collateral for repurchase agreements is no longer permitted. "Blind pooled" hold-in-custody repurchase transactions occur when a seller does not deliver securities and does not identify specific securities as belonging to specific customers. Instead, the financial institution sets aside, or otherwise designates, a pool of securities to collateralize its outstanding repurchase obligations. The regulations require that the written confirmation sent to a customer must identify the specific securities that are the subject of the hold-in-custody repurchase transaction. A specific security identified to a customer must be in an authorized denomination, that is, in a deliverable par amount.

### Broker/Dealer Notification Requirements

A much more limited number of thrift institutions are subject to the broker/dealer notification requirements set forth in the GSA. Thrift institutions that are government securities brokers or dealers are required to notify OTS of their status upon becoming a government securities broker or dealer and to comply with applicable requirements relating to those activities.

A thrift institution will generally be considered a government securities broker if it engages in the following government securities activities:

- Representing itself as a government securities broker or inter-dealer broker, or
- Actively soliciting purchases or sales of government securities on an agency basis.

A thrift institution will generally be considered a government securities dealer if it engages in the following government securities activities:

- Underwriting or participating in a selling group for the sale of government securities;
- Advertising or otherwise representing itself to other dealers or investors as a dealer in government securities; or
- Quoting a market for government securities, and in connection with such quotations, standing ready to purchase or sell government securities.

A thrift institution that buys or sells government securities solely for investment for its own account or accounts for which it acts as fiduciary will not generally be considered as a broker or dealer and subject to notification requirements, even if such purchases and sales are made with some frequency. Although still subject to custodial holding (except for savings bond transactions) and hold-in-custody repurchase agreement requirements, a thrift may engage solely in the following government securities activities without filing a written notice or associated requirements:

- Issuing or handling savings bond transactions (exemption from custodial holding requirements permitted);
- Submitting tenders for the account of customers for purchase on original issues of U.S. Treasury securities;
- Engaging in limited government securities dealer activities, such as entering into repurchase or reverse repurchase agreements, or sales or purchases in a fiduciary capacity; or
- Engaging in limited brokerage activities: either effecting fewer than 500 government securities brokerage transactions per year, or effecting brokerage transactions only through another government securities broker or dealer on a fully disclosed basis where its employees perform only clerical, ministerial, or order-taking functions.

Notice by thrift institutions of their government securities broker or dealer activities is to be filed with OTS on Forms G-FIN and G-FIN-4. Once an institution has filed notice of its status as a government securities broker or dealer, any changes to the status of its filing must be reported within 30 days. If a thrift institution ceases its government securities activities, it must file a notice of termination using Form G-FINW. See Appendix A for exhibits of the current G-FIN and G-FINW forms.

## References

### Code of Federal Regulations (17 CFR)

*Chapter IV: Department of the Treasury*

*Subchapter A: Regulations under Section 15c of the Securities and Exchange Act of 1934*

*Subchapter B: Regulations under Title II of the Government Securities Act of 1986*

Part 450--Custodial Holdings of Governmental Securities by Depository Institutions

PL 99-571 The Government Securities Act of 1986

Form G-FIN (Department of Treasury) - Notice by Financial Institutions of Government Securities Broker or Government Securities Dealer Activities

Form G-FINW (Department of Treasury) - Notice by Financial Institutions of Termination of Activities as a Government Securities Broker or Government Securities Dealer

Department of Treasury Staff Interpretation of Regulations Implementing the Government Securities Act of 1986 - Letter from Bureau of Public Debt dated April 19, 1996, clarifying GSA record-keeping requirements regarding forward repurchase agreement transactions

OTS Trust Activities Handbook Section 300